

Message Text

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SUBJECT: DEVALUATION DEBATE HEATS UP (AGAIN)

REF: (A) CANBERRA 4477, (B) CANBERRA 0012

1. IN THE PAST TWO WEEKS THE CONTINUING PUBLIC DEBATE OVER AUSTRALIAN DOLLAR DEVALUATION HEATED UP. THIS DEBATE HAS ALTERNATELY SMOLDERED AND FLARED SINCE THE PRESENT GOVERNMENT TOOK OFFICE IN DECEMBER 1975. THE NEWEST UPSURGE OF THIS CONTROVERSY LED BY SEPTEMBER 15 TO THE LATEST AND ONE OF THE MOST EMPHATIC OF THE GOVERNMENT'S SUCCESSIVE DENIALS THAT ITS ECONOMIC STRATEGY HAD ANY ROOM FOR DEVALUATION.

2. DURING THE PAST SIX MONTHS AUSTRALIAN MINING INTERESTS, INDIVIDUALLY AS WELL AS IN CONCERT THROUGH THE LIMITED OFFICIAL USE

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AUSTRALIAN MINING INDUSTRY CONGRESS, HAVE LOBBIED HARD FOR

DEVALUATION, WHICH THEY ASSERT IS REQUIRED BOTH TO IMPROVE AUSTRALIAN EXPORT COMPETITIVENESS AND MAKE DEVELOPMENT COSTS MORE ATTRACTIVE TO FOREIGN INVESTORS. NUMEROUS OTHER VOICES FAVORING DEVALUATION HAVE BEEN RAISED FROM THE MANUFACTURING AND AGRICULTURAL SECTORS. THE FINANCIAL COMMUNITY HAS IN GENERAL STRONGLY SUPPORTED THE GOVERNMENT'S FIRM POSITION THAT DEVALUATION WOULD BE SERIOUSLY COUNTERPRODUCTIVE IN THE OVERRIDING EFFORT TO REDUCE INFLATION (ALTHOUGH A GROWING NUMBER OF BANKERS ARE ACCEPTING THE INEVITABILITY OF SUCH A MOVE AND A FEW ARE BEGINNING TO SUGGEST PRIVATELY THAT IT MAY BE DESIRABLE IN ORDER TO STIMULATE FOREIGN INVESTMENT INFLOW AND RESIST BALANCE OF PAYMENTS DETERIORATION).

3. AN UNEXPECTED NEW ELEMENT WHICH CONTRIBUTED IMPORTANTLY TO THE FLARE-UP OF THE PAST TWO WEEKS WAS A SEPTEMBER 6 STATEMENT BY FORMER ALP TREASURER AND CURRENT SHADOW DEFENCE MINISTER HAYDEN TO THE EFFECT THAT "BLIND FREDDY AND HIS DOG" KNEW THAT THE AUSTRALIAN DOLLAR WAS OVERVALUED. HAYDEN ALLUDED WITH APPARENT AGREEMENT TO OBSERVERS WHO HAD SUGGESTED THE CURRENT OVERVALUATION WAS APPROXIMATELY 15 PERCENT. HAYDEN'S PROVOCATIVE STATEMENT TOUCHED OFF FURTHER EXCHANGES IN THE COURSE OF WHICH THE PRIME MINISTER AND THE TREASURER FIRMLY REITERATED THE GOVERNMENT'S ROCK-LIKE ANTI-DEVALUATION STAND. NEVERTHELESS, HAYDEN'S OUTBURST STIMULATED FURTHER EXCHANGES IN WHICH MANY MORE ACADEMIC AND BUSINESS FIGURES VARIOUSLY SUPPORTED OR OPPOSED NEAR-TERM DEVALUATION. AT THE HEIGHT OF THIS EXCHANGE, A SEPTEMBER 13 SPEECH BY THE DEPUTY PRIME MINISTER AND MINISTER FOR OVERSEAS TRADE, MR. ANTHONY, DISCUSSING SOMEWHAT PESSIMISTICALLY THE AUSTRALIAN TRADE OUTLOOK WAS WIDELY INTERPRETED AS PROJECTING DETERIORATION AND IMPLYING EVENTUAL DEVALUATION. THIS PROVOKED ANOTHER ROUND OF STRONG DENIALS BY THE PRIME MINISTER AND OTHER SENIOR CABINET OFFICIALS INCLUDING ANTHONY HIMSELF. THESE DENIALS ON SEPTEMBER 14 WERE REINFORCED BY A STRONG STATEMENT FROM THE HEAD OF THE BANK OF NEW SOUTH WALES, AND REPORTEDLY BY THE MEMBERS OF THE GOVERNMENT'S RECENTLY FORMED ECONOMIC CONSULTATIVE GROUP IN THE COURSE OF ITS SEPTEMBER 14 MEETING IN CANBERRA.

4. THE VERY STRONG PUBLIC POSITION RE-ASSERTED BY THE LIMITED OFFICIAL USE

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PRIME MINISTER AND TREASURER DURING THE PAST WEEK WILL PROBABLY TEND TO DAMPEN THE CURRENT UPSURGE OF CONTROVERSY ON THE DEVALUATION ISSUE AND RETURN THE TOPIC TO ANOTHER PERIOD OF CONTINUING LOWER-KEY DEBATE PENDING FURTHER SIGNIFICANT DEVELOPMENTS ON THE INTERRELATED ISSUES OF THE TRADE BALANCE, CAPITAL INFLOW, AND THE CPI TREND. FOR THE LONGER RUN, THE PROSPECT IS LESS CLEAR. THERE IS NO QUESTION OF THE VERY HIGH IMPORTANCE WHICH THE GOVERNMENT NOW

ATTACHES TO AVOIDANCE OF DEVALUATION AS A CENTRAL FEATURE OF ITS FIGHT TO REDUCE INFLATION. THE PRIME MINISTER HAS FIRMLY ASSERTED AND ADHERED TO THIS STRATEGY SINCE HE ASSUMED OFFICE. THE PRIMACY OF THE INFLATION FIGHT IS REFLECTED IN THE POLITICALLY PAINFUL STEPS THE GOVERNMENT HAS BEEN WILLING TO TAKE WITH RESPECT TO THE 1977 BUDGET, AND ITS INCREASINGLY CANDID AVOWAL OF THE GOAL OF REDUCING REAL WAGES BY MODIFYING THE PAST CPI INDEXATION FORMULA. DURING THE PAST YEAR, MOREOVER, THE GOVERNMENT HAS EVIDENCED ITS DETERMINATION TO DEFEND THE AUSTRALIAN DOLLAR BY ITS RESORT TO INTERNATIONAL BORROWING TO OFFSET A GRADUAL DOWNTREND IN RESERVES. THESE INCLUDE THE IMF DRAWING OF ALMOST \$400 MILLION IN JULY, AS WELL AS THE EARLIER \$200 MILLION LOAN THROUGH MORGAN IN NEW YORK AND THE \$300 MILLION FINANCING NOW PENDING IN EUROPE. THE OVERALL LOGIC OF THE GOVERNMENT'S ECONOMIC STRATEGY, AS WELL AS THE STRONG COMMITMENTS REPORTED TO HAVE BEEN EXPRESSED BY THE PRIME MINISTER IN HIS JULY DINNER WITH U.S. BUSINESS LEADERS IN NEW YORK AND THE TONE AND CIRCUMSTANCES OF THE RECENT ASSURANCES ALL SUGGEST THAT AT LEAST FOR THE PRESENT THE GOVERNMENT'S STATEMENTS ON DEVALUATION MEAN EXACTLY WHAT THEY SAY.

5. FOR THE LONGER PULL, BEYOND DECEMBER 1 AND THROUGH THE FIRST HALF OF 1977, THE PROSPECT IS LESS CERTAIN. THERE IS NO REASON TO ASSUME AN INCREASE IN THE MERCHANDISE EXPORT SURPLUS OVER THE COMING YEAR, BARRING MAJOR CHANGES IN IMPORT POLICY. HIGH DOMESTIC PRICES CONTINUE TO FAVOR MANY IMPORTS AND THE UPWARD IMPORT TREND WILL BE REINFORCED IF AND WHEN INDUSTRIAL PRODUCTION SHOWS ANY SUSTAINED REVIVAL. THE PROSPECT FOR A STRONG REVIVAL OF INVESTMENT INFLOW WITH OR WITHOUT DEVALUATION IS UNCLEAR. OUR IMPRESSION IS THAT MUCH OF THE LAG IN INVESTMENT REPRESENTS THE NORMAL LONG LEAD TIME IN MASSIVE MINERAL PROJECTS, WHILE THE PROSPECTS OF CONTINUING LIMITED OFFICIAL USE

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INFLATION, MARKET UNCERTAINTIES AND LOW LABOR PRODUCTIVITY PROBABLY DETERMINE INVESTMENT THAN THE ABSOLUTE LEVEL OF THE EXCHANGE RATE. ON THE INFLATION FRONT, THE GOVERNMENT WAS PLEASED WITH THE UNADJUSTED ANNUAL RATE OF 10 PERCENT ACHIEVED FOR THE JUNE QUARTER, BUT MUCH OF THIS APPEARS TO HAVE BEEN DUE TO UNUSUALLY FAVORABLE FOOD PRICE FACTORS AND THE PROSPECT IS THAT THE RATE WILL GO HIGHER BEFORE IT DROPS BELOW THIS LEVEL.

MOREOVER, AS UNEMPLOYMENT SETS A NEW RECORD UNDER THE INFLUENCE OF THE AUSTERE 1977 BUDGET JUST TABLED AND WITH THE ADDITION OF A NEW CROP OF SCHOOL-LEAVERS TO THE WORK FORCE IN DECEMBER, THE GREAT CURRENT PRESSURE IN ALL POLITICAL QUARTERS FOR A DRAMATIC NEW ECONOMIC INITIATIVE MAY BECOME IRRESISTIBLE. IF BY THAT TIME THE GOVERNMENT HAS CONTINUED TO BE SUCCESSFUL IN SQUEEZING DOWN THE RATIO OF

WAGE INDEXATION AND SEES EVIDENCE OF PROGRESS ON THE INFLATION RATE, THE TEMPTATION TO ACHIEVE IN ONE MOTION ADDITIONAL IMPORT PROTECTION, HOPEFULLY ADDITIONAL INVESTMENT INFLOW, SOME BALANCE OF PAYMENTS HELP, AND A GREAT DEAL OF POLITICAL RELIEF MAY PERSUADE THE GOVERNMENT TO ADOPT A PACKAGE WHICH INCLUDES DEVALUATION, EVEN AT THE COST OF A MODEST INFLATIONARY OFFSET.

6. CONSIDERING ALL OF THESE FACTORS, THE POSSIBILITY OF SOME DEVALUATION MOVE AT THE END OF 1976 OR IN THE FIRST HALF OF 1977, THOUGH BY NO MEANS CERTAIN, APPEARS TO US VERY STRONG. BUT IT APPEARS PROBABLE THAT THE PRIME MINISTER AND THE GOVERNMENT WILL CONTINUE FOR THE IMMEDIATE FUTURE TO ADHERE TO THE TOUGH-MINDED DEFLATIONARY STRATEGY EXEMPLIFIED BY THE BUDGET TABLED IN SEPTEMBER. THIS INCLUDES MARGINAL REDUCTION IN REAL WAGES BY LESS THAN FULL CPI INDEXATION, TIGHT CONTROL ON MONEY SUPPLY AND FIRM RELIANCE ON THE ASSUMPTION THAT THE PRIVATE SECTOR WILL BEGIN TAKING UP THE ECONOMIC SLACK BEFORE GROWING POLITICAL PRESSURE FOR RELIEF FORCES IT INTO A SOFTER POLICY. HARGROVE

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